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No. 173

In the Supreme Court of the United States.

OCTOBER TERM, 1951

JOSEPH T. LYKES, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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OPINIONS BELOW

The opinion of the Court of Appeals (R. 58-63) is reported at 188 F. 2d 964. The memorandum opinion of the District Court (R. 44-49) is reported at 84 F. Supp. 537.

JURISDICTION

The judgment of the Court of Appeals (R. 63) was entered on April 27, 1951. The petition for

a writ of certiorari was filed on July 5, 1951. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTION PRESENTED

Whether the taxpayer is entitled under Section 23(a)(2) of the Internal Revenue Code to deduct from gross income the amount he paid as attorney's fees in connection with a dispute as to his gift tax liability between himself and the Commissioner of Internal Revenue.

STATUTE AND REGULATIONS INVOLVED

These are set out in the Appendix, *infra,* pp. 12-17.

STATEMENT

The facts as found by the District Court (R. 44-46) are as follows:

The taxpayer is and has been for many years a stockholder in Lykes Brothers, Inc., a family corporation. The stock of the corporation has been closely held throughout its existence and there is not nor has there ever been an open market price for the stock. In the year 1940 taxpayer made gifts of 1,000 shares of stock of the corporation, owned by him, to members of his family, as follows (R. 44):

250 shares to Margaret K. Lykes, his wife
250 shares to Margaret H. Lykes, his daughter
250 shares to Elizabeth L. Lykes, his daughter
250 shares to Joseph T. Lykes, Jr., his son

It appears from the testimony that one of the daughters had reached her majority at the time of the gifts, but the other two children were minors. All of the children made their home with the taxpayer, were unmarried and neither the wife nor the children took any part in the management of the business of Lykes Brothers, Inc., at the time of the gifts. (R. 44.)

The motive for the gifts, as stated in the taxpayer's gift tax return, was love. The taxpayer testified to additional motives, the principal of which was the accepted custom or policy of himself and his brothers to make such gifts to their children to insure continuity of the ownership and management of the company. The evidence shows this custom has been pursued by other members of the Lykes family. (R. 45.)

At the time the gift tax return was filed, taxpayer valued the stock at $120 per share and paid a gift tax thereon in the sum of $13,032.75. The taxpayer testified he took as a guide in determining the value of the stock the only arm's-length transaction of importance during that year of which he had knowledge—the sale of several hundred shares by an executive (not a member of the Lykes family) to other executives of the company. He testified he also took into consideration the hazards then confronting the business and reached the conclusion that the market value established

by the sale represented the fair value of the stock at the time. (R. 45.)

On March 3, 1944, the Commissioner of Internal Revenue formally notified the taxpayer that a determination of his gift tax liability for 1940 disclosed a deficiency of $145,276.50 and a deficiency in that amount was assessed against taxpayer. He also was notified of his right to petition the Tax Court for a redetermination of such deficiency liability. (R. 45.)

The taxpayer engaged K. I. McKay to represent him in this matter and a petition for redetermination of the liability was filed with the Tax Court. After taxpayer's attorney had prepared and filed such petition and prepared his case for trial, a compromise settlement was reached and the Tax Court, pursuant to stipulation of the parties, found a deficiency in taxpayer's gift tax return in the sum of $15,612.75, which was promptly paid. The taxpayer paid his attorney $7,263.83 in the year 1944 for services in this matter. (R. 45-46.)

The taxpayer did not deduct the $7,263.83 in his income tax return for 1944, but later claimed the right to deduct it. (R. 3-4.) The Commissioner disallowed such deduction (R. 14), but the District Court entered a decision in favor of the taxpayer (R. 49). The Court of Appeals reversed the judgment of the District Court. (R. 63.)

ARGUMENT

Section 23(a)(2) of the Internal Revenue Code, Appendix, *infra*, pp. 12-13, provides for the deduction of "all the ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income." The Court of Appeals held that the legal fees paid in connection with the taxpayer's contest of a gift tax deficiency did not come within the purview of this statutory provision and hence are not deductible. This decision is in harmony with the only other decision involving the same question (*Cobb* v. *Commissioner*, 173 F. 2d 711 (C.A. 6th), certiorari denied, 338 U. S. 832,[1] rehearing denied, 338 U. S. 882) and is plainly correct on both the statutory language and its purpose. It is expressly directed by the Treasury Regulations[2] and is consonant with the decision of this Court in *Trust of Bingham* v. *Commissioner*, 325 U. S. 365.

1. Not every non-business expense is deductible under Section 23(a)(2). The test is whether the expense for which a deduction is sought is one

[1] Mr. Justice Black and Mr. Justice Jackson were of the opinion that certiorari should be granted.

[2] The regulation states a reasonable rule, and it should be sustained as a permissible application of the statute, even though it might be thought, contrary to our view, that a converse rule would also be possible. Cf. *Helvering* v. *Reynolds*, 313 U. S. 428; *Murphy Oil Co.* v. *Burnet*, 287 U. S. 299; *Brewster* v. *Gage*, 280 U. S. 327.

which is proximately related to the production or collection of income or to the care or conservation of property held to produce income. H. Rep. No. 2333, 77th Cong., 2d Sess., pp. 74-75 (1942-2 Cum. Bull. 372, 429-430); S. Rep. No. 1631, 77th Cong., 2d Sess., pp. 87-88 (1942-2 Cum. Bull. 504, 570-571); Section 29.23(a)-15(a) of Treasury Regulations 111, Appendix, *infra*, pp. 13-15. But expenses incurred in contesting gift tax liability bear no such relation to the production of income nor to the management or conservation of income-producing property. A gift is by its very nature personal. The gratuitous disposition of property can hardly be termed production of income.[3] Moreover, it seems clear that the profitless separation from the taxpayer of some of his property cannot be even remotely considered to be an integral part of the management or conservation of one's estate, for it is not an activity calculated to enlarge one's estate but rather to diminish it.[4] Thus, the expenses here involved were "personal" or "family expenses" expressly made nondeductible by Sec-

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[3] If the gratuitous disposition of property were an act designed to produce income, then the value of the gift would be a deductible expense under Section 23(a)(2) of the Code.

[4] In *Cobb* v. *Commissioner*, *supra*, it was argued that the enforcement of a deficiency for gift taxes in a case of this type would constitute a lien on property held by the donor for the production of income. However, the acceptance of such a theory would lead to the allowance of expenses in defending any action, such as one for personal injuries, that might result in a judgment lien on the taxpayer's income-producing property. See *Willmott* v. *Commissioner*, 2 T. C. 321, and Note, 63 Harv. L. Rev. 357 (1949).

tion 24(a)(1) of the Internal Revenue Code, Appendix, *infra*, p. 13.

Section 29.23(a)-15(b) of Treasury Regulations 111, Appendix, *infra*, p. 17, expressly states in part—

> expenses paid or incurred by an individual in the determination of gift tax liability, * * * are not deductible, even though property held by him for the production of income must be sold to satisfy an assessment for such tax liability * * *

This was promulgated as a result of the decision in *Trust of Bingham* v. *Commissioner*, 325 U. S. 365. See T. D. 5513, 1946-1 Cum. Bull. 61, 62. The taxpayer contends (Br. 19-20), however, that instead of following the principles announced in the *Bingham* case, the Treasury has rejected those principles. This view is erroneous. In the *Bingham* case expenses attendant upon the distribution to beneficiaries of trust principal and income were held deductible only because they were "expenses of a function of 'management' of the trust property." (325 U. S. 375.) They were such only because "the duties of the trustees" included a fiduciary obligation "to distribute the income and the principal so held from time to time, and the remainder of the principal at the expiration of the trust. Performance of each of these duties [was] an integral part of carrying out the trust enter-

prise." But here the taxpayer was under no obligation whatever to make gifts to his children. The act of donation was not an act of "management, conservation or maintenance of property held for the production of income." In fact, taxpayer's reliance on the *Bingham* decision particularly emphasizes the correctness of the position of the Court of Appeals. Taxpayer argues (Br. 19) that "whatever this Court in the *Bingham* case said of the management of a trust is also true of the management of an individual's income-producing fund of property." However, as stated *supra*, in the *Bingham* trust a fiduciary obligation to the beneficiaries was being carried out; here only a man's obligation to himself was being effectuated. Thus the personal nature of this expense is further illustrated, and the Court of Appeals correctly refused to accept the impractical concept that giving away property produced income to the taxpayer.

2. It is further argued (Br. 14-19) that the question of the proximate relationship between the expense and the management of the income-producing property is essentially one of fact, and that since there are several evidentiary facts supporting the conclusion that the expense was proximately related to the management of conservation of income-producing property, the case should have been remanded by the Court of Appeals for additional findings of fact and conclusions of law before a final determination. Initially this argument mis-

conceives the nature of the question here involved. The evidentiary facts dispositive of this case are undisputed. The nature of the transferred property, the fact of the gift and all other relevant attendant circumstances were all found by the District Court and have not been and are not challenged. The Court of Appeals decided a question of law. Indeed, the case that the taxpayer relies on (Br. 14) for the proposition that his case involves a question of fact (*Trust of Bingham* v. *Commissioner*, *supra*) explicitly states that this type of question is one of law (325 U. S. at 371):

> The questions whether, on the facts found, the expenses in question are nondeductible, either because they were not to produce income or because they were related to the management of property which was not held for the production of income, turn in this case on the meaning of the words of § 23(a)(2), "property held for the production of income." They are therefore questions of law, decision of which is unembarrassed by any disputed question of fact or any necessity to draw an inference of fact from the basic findings.

Even assuming, *arguendo*,[5] that a question of fact is presented in this case, it seems manifest that the taxpayer's position is untenable. The scope of review by the Court of Appeals in that situation

[5] If the result in this type of case depends on a resolution of the particular facts involved, then it is plainly not a proper case for the granting of a petition for certiorari.

would be whether or not the finding by the trial court was clearly erroneous. Presumably the taxpayer argues that this means that if there is any basis for supporting the conclusion of the lower court, then the appellate court may not reverse. However, as this Court stated in *United States* v. *Gypsum Co.*, 333 U.S. 364, 395:

> A finding is "clearly erroneous" when although there is evidence to support it, the reviewing court on the entire evidence is left with the definite and firm conviction that a mistake has been committed.

See also *United States* v. *Yellow Cab Co.*, 338 U.S. 338, 340-342. Thus the Court of Appeals in reversing the trial court was acting clearly within the proper scope of judicial review.

CONCLUSION

The decision of the court below is not in conflict with any other decision. It is a correct interpretation of the taxing statute and is required by the Treasury Regulations. It is, therefore, respectfully submitted that the petition for a writ of certiorari should be denied.

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THERON LAMAR CAUDLE,
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Special Assistants to the Attorney General.

AUGUST, 1951.

Internal Revenue Code:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) [as amended by Sec. 121(a), Revenue Act of 1942, c. 619, 56 Stat. 798] *Expenses.*—

(1) *Trade or Business Expenses.*—

(A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he had no equity.

* * * * * * *

(2) *Non-trade or non-business Expenses.*—In the case of an individual, all the ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income, or for the management, conservation, or maintenance

of property held for the production of income.

* * * * * *

(26 U.S.C. 1946 ed., Sec. 23.)

SEC. 24. ITEMS NOT DEDUCTIBLE.

(a) *General Rule.*—In computing net income no deduction shall in any case be allowed in respect of—

(1) Personal, living, or family expenses;

* * *

* * * * * *

(26 U.S.C. 1946 ed., Sec. 24.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

SEC. 29.23(a)-15. *Nontrade or Nonbusiness Expenses:*

(a) *In general.*—Subject to the qualifications and limitations in chapter 1 and particularly in section 24, an expense may be deducted under section 23(a)(2) only upon the condition that:

(1) it has been paid or incurred by the taxpayer during the taxable year (i) for the production or collection of income which, if and when realized, will be required to be included in income for Federal income tax purposes, or (ii) for the management, conservation, or maintenance of property held for the production of such income; and

(2) it is an ordinary and necessary expense for either or both of the purposes stated in (1) above.

The term "income" for the purpose of section 23(a)(2) comprehends not merely income of the taxable year but also income which the taxpayer has realized in a prior taxable year or may realize in subsequent taxable years; and is not confined to recurring income but applies as well to gains from the disposition of property. For example, if defaulted bonds, the interest from which if received would be includible as income, are purchased with the expectation of realizing capital gain on their resale, even though no current yield thereon is anticipated, ordinary and necessary expenses thereafter incurred in connection therewith are deductible. Similarly, ordinary and necessary expenses incurred in the management, conservation or maintenance of a building devoted to rental purposes are deductible notwithstanding that there is actually no income therefrom in the taxable year, and regardless of the manner in which or the purposes for which the property in question was acquired. Expenses incurred in managing, conserving or maintaining property held for investment may be deductible under this provision even though the property is not currently productive and there is no likelihood that the property will be sold at a profit or will otherwise be productive of income and even though the property is held merely to

minimize a loss with respect thereto. The expenses, however, of carrying on transactions, which do not constitute a trade or business of the taxpayer and are not carried on for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income, but which are carried on primarily as a sport, hobby, or recreation are not allowable as nontrade or nonbusiness expenses.

Expenses, to be deductible under section 23(a)(2) must be "ordinary and necessary," which presupposes that they must be reasonable in amount and must bear a responsible and proximate relation to the production or collection of taxable income or to the management, conservation, or maintenance of property held for the production of income.

(b) [as amended by T. D. 5513, 1946-1 Cum. Bul. 61, 62] Except for the requirement of being incurred in connection with a trade or business, a deduction under this section is subject to all the restrictions and limitations that apply in the case of the deduction under section 23(a)(1)(A) of an expense paid or incurred in carrying on any trade or business. This includes restrictions and limitations contained in section 24. * * * Nor does section 23(a)(2) allow any expenses which are disallowed by any of the provisions of chapter 1. Capital expenditures, and expenses of carrying on transactions which do not constitute a trade or business of the taxpayer and are not carried on for the production or collec-

tion of income or for the management, conservation, or maintenance of property held for the production of income, but which are carried on primarily as a sport, hobby, or recreation are not allowable as nontrade or nonbusiness expenses. The question whether or not a transaction is carried on primarily for the production of income or for the management, conservation, or maintenance of property held for the production or collection of income, rather than primarily as a sport, hobby, or recreation, is not to be determined solely from the intention of the taxpayer but rather from all the circumstances of the case, including the record of prior gain or loss of the taxpayer in the activity, the relation between the type of activity and the principal occupation of the taxpayer, and the uses to which the property or what it produces is put by the taxpayer.

* * * * *

Expenses paid or incurred by an individual in the determination of liability for taxes upon his income are deductible. If property is held by an individual for the production of income, amounts expended in determining a property tax imposed with respect to such property during the period when so held are deductible. Expenses paid or incurred by an individual in determining or contesting any liability asserted against him do not become deductible, however, by reason of the fact that property held by him for the production of

income may be required to be used or sold for the purpose of satisfying such liability. Thus, expenses paid or incurred by an individual in the determination of gift tax liability, except to the extent that such expenses are allocable to interest on a refund of gift taxes, are not deductible, even though property held by him for the production of income must be sold to satisfy an assessment for such tax liability or even though, in the event of a claim for refund, the amount received will be held by him for the production of income.

* * * * *

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